Tax News
for tax professionals

Tax News
July 2007

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A progress report on the 20-year statute of limitations

The Franchise Tax Board wrote off 373,819 liabilities during the period July 1, 2006, through May 30, 2007, for a total dollar amount of $3,219,766,558 under the new 20-year statute of limitations enacted as part of AB 911.

The 20-year statute of limitations on the collection of tax liabilities, as provided by Revenue and Taxation Code Section 19255, sets the period during which tax may be collected as up to 20 years from the last statutory lien date for each tax year. After that date, the liability for the tax year is written off. Before AB 911 became law, there was no statute of limitations on the collection of tax liabilities.

20-Year Statute of Limitations Results	July 1, 2006 – May 30, 2007
Number of tax year liabilities written off	373,819
Dollar amount written off	$3,219,766,558

FTB and IRS warn taxpayers of email tax scam

On May 31, the IRS and FTB warned computer users of an ambitious email scam discovered by the IRS, that involved both the IRS and FTB. People targeted by the scam received a phony email falsely stating that they were under criminal investigation by the IRS for submitting a false return to FTB. The intent of the email was to convince email recipients to open up an attachment that would give the scam operators remote access to the recipients' computers.

This type of email scam is an example of "phishing" – a technique aimed at obtaining personal information for the purpose of identity theft. Neither the IRS nor FTB send unsolicited emails, and will never ask taxpayers for detailed personal financial information like PINs, passwords, or other credit card or bank information via unsolicited emails.

If you or your clients have any questions about the security of questionable emails or phone calls purporting to be from FTB, contact us at (800) 852-5711. Review our policy on identity theft on our Website.

California Schedule K-1 redesign

Transferring amounts from federal K-1s to California Schedule K-1s will soon be easier. We are modifying our Schedule K-1s (forms 100S, 565, 568, and 541) by reordering line items to make them similar to the line item order on federal Schedule K-1s. Instructions for K-1s will also include a new chart that cross-references the boxes and codes on the federal K-1s to the appropriate line items on the California K-1s.

You can review the draft versions of the revised California K-1 on our Website, along with the new instructional chart. Computerized tax processors may access the drafts at the CTP Website.

California's Compliance Resolution Program for 409A taxes

In February 2007, the IRS created a Compliance Resolution Program (Announcement 2007-18) that permitted employers to pay their rank-and-file employees' additional taxes arising under Internal Revenue Code (IRC) Section 409A. These additional taxes are due to employees' exercise of certain discounted stock options and stock appreciation rights in 2006. California's Revenue and Taxation Code (R&TC) Sections 17501 and 24601 allows IRC Section 409A to apply to California taxpayers.

After the IRS established its Compliance Resolution Program, FTB issued FTB Notice 2007-1, *California's Compliance Resolution Program for Employers Participating, or Intending to Participate, in the IRS Compliance Resolution Program Regarding Internal Revenue Code Section 409A*, (California Program). The California Program parallels the IRS Program. Employers were required to file a notice of intent to participate in the California Program with FTB by March 15, 2007. Find more information on FTB Notice 2007-1, and additional instructions, on our Website at www.ftb.ca.gov (search for **409A)**.

The California Program allowed employers to step forward and pay the additional 20 percent tax, and interest tax that employees owed. For California purposes, the interest tax component of Section 409A is calculated using California's highest marginal tax rate in effect for 2005 (9.3 percent), and the interest rate applicable for underpayments under California law, plus one percent.

The 409A taxes paid in 2007 on behalf of an employee by an employer participating in the California Program are additional compensation to the employee, and should be included in the employee's 2007 Form W-2. Employees may choose to modify their withholding or estimated tax payments for 2007 in anticipation of this additional compensation.

If you have clients who owe the additional 409A 20 percent tax and interest, they remain liable for these amounts on their 2006 California income tax returns, if their employers did not participate in the California Program, or failed to fulfill the California Program requirements.

Head of Household audit letters begin arriving in July

Each year we review the returns of taxpayers who claim the Head of Household (HOH) filing status because the qualifications for the filing status are often misunderstood. This year we expect to mail approximately 150,000 *HOH Audit Letters* for the 2006 tax year between

July and December 2007.

HOH audit staff review the completed questionnaires to determine if taxpayers qualify for the HOH filing status. If the *Audit Letter* questionnaire is incomplete, or provides conflicting information, we contact taxpayers to resolve the issue. When the HOH filing status is confirmed, we send an acceptance letter to qualified taxpayers. Acceptance letters only apply to the specific tax year examined and do not qualify the taxpayer for any other tax year.

Taxpayers who don't respond to the questionnaire, or whose responses indicate that they don't qualify as HOH, can expect a *Notice of Proposed Assessment* that disallows their HOH filing status. If you have clients who receive an audit letter, advise them to respond by the letter's due date to avoid a failure to furnish information penalty.

HOH and e-file

Taxpayers who e-file and claim the HOH filing status, have the option of electronically completing and including an HOH questionnaire (*HOH Schedule* FTB 4803E) with their e-filed return. We will not mail an *HOH Audit Letter* to taxpayers who submitted this information electronically. They may, however, still receive a follow-up audit letter if they provide incomplete or conflicting information.

New this year

Your clients with Internet access can answer the 2006 *HOH Audit letter* at www.ftb.ca.gov. They should:

- Access the HOH Webpage.
- Click on the HOH Audit Letter Web Response Application (taxpayers will need their FTB ID number, which is printed on the *HOH Audit Letter,* and their social security number).

Taxpayers who use this application do not need to mail or fax their response to us.

You and your clients can get more information about the HOH filing status, and can access the HOH Web Response Application by visiting our HOH Webpage.

What's new at FTB? Our Speakers' Bureau can tell you

The Speakers' Bureau is one of the ways that we strive to meet the continuing educational needs of tax professionals and nonprofit, tax-related organizations. We are available to help community and professional groups, nonprofit organizations, and government-funded educational institutions learn more about tax-related issues by providing speakers who can give you the details and the latest updates on a variety of tax-related topics. Some of the topics our speakers have recently presented are listed below.

Recent presentations:

- Audit Process.

- Collection Process.
- Corporate Dissolutions.
- e-file Program.
- Exempts Overview.
- FTB Fraud Programs.
- Forms of Ownership.
- Head of Household.
- Nonresident Issues.
- Offer in Compromise.
- Real Estate Withholding.
- Registered Domestic Partners.
- Tax Credits and Incentives.
- Tax Legislation Update.
- Tax Gap.
- Top Audit Issues.
- What's new at FTB?

FTB speakers typically make brief presentations to groups of 25 or more. If you are interested in requesting one of the listed presentations, or if you have ideas for other presentations, contact Steve Sims at (916) 845-7565, at least 30 days before your event.

Notes from the tax practitioner liaison

Introducing FTB's tax practitioner liaison

If you are wondering, “Who is the tax practitioner liaison?” - let me introduce myself. I am Susan Maples, and I'm the FTB tax practitioner liaison. My job is to work closely with the practitioner community to identify and communicate important issues between practitioners and FTB. Each month I hope to include interesting information in my notes that may be timely and useful in your practice. I welcome your comments and suggestions for general practitioner issues. You can contact me with these issues at Susan.Maples@ftb.ca.gov. As always, if you have specific client (taxpayer) issues, please use our Tax Practitioner Hotline (916) 845-6377.

Tax practitioner Hotline

For the past five months, the Practitioner Hotline has experienced an unexpected high volume of phone calls and correspondence – a 72 percent increase since this time last year. One result of this high volume is that our customers are waiting longer for responses from our Hotline staff. Some calls are not getting through, and it is taking us longer to respond to your correspondence.

In addition to the dramatic increase in our Hotline workload volume, we recently added collection correspondence to our list of responsibilities. To cope with these increases, we added eight new staff to the Hotline – five just recently. Twelve of our 18 employees staff the Hotline, and the remaining six answer FAX and collection correspondence.

Once our new staff is up-to-speed, we should see our phone access improve and a reduction in the turn-around time for your correspondence.

You may be able to help us. When you request account transcripts for your clients, please ask only for what you need. We get many requests for tax computations or transcripts, for 10 or more tax years. Researching the account and building your computation can take hours, which is time away from the phones. We suggest asking for only the years within statute, and any open years. This will cover any tax years with a credit or balance due that are in our system.

Inside FTB

New contact for RAR workshops

The June edition of *Tax News* announced the availability of Head of Household (HOH) and Revenue Agent Report (RAR) workshops. Due to a staffing change, our point of contact for the RAR workshop has changed. If you would like to schedule a workshop or would like more information, please contact either of the following individuals:

Revenue Agent Report Workshop

Coordinator: Estela Evangelista
Telephone: (916) 845-7359
Email: estela.evangelista@ftb.ca.gov
Fax: (916) 843-6138

Head of Household Workshop

Coordinator: Bonnie Hoyle
Telephone: (916) 845-3959
Email: hohwebpage@ftb.ca.gov
Fax: (916) 843-5449

Where are the new subscription services?

In our June issue, we described several new subscription services we are offering, and referred readers to our subscription services page. After going to press, unexpected system problems significantly delayed the June launch of “subscription services phase two” - we have been working diligently to solve the problems, and expect the new subscription services to be available in July. We are sorry for any inconvenience this may have caused.

Criminal Corner

We are committed to closing California’s $6.5 billion tax gap, defined as the difference between tax that is owed, and tax that is paid. Our special agents work cooperatively with law enforcement agencies throughout California to uncover illegal behaviors that contribute to the tax gap. These include underreporting income, overstating deductions, failing to file returns, failing to pay taxes due, and making illegal cash payments to employees.

Tax fraud is not a victimless crime. You can report suspected tax fraud by calling FTB at (800) 540-3453.

Missing woman’s ex-husband charged with tax evasion, other crimes

Originally reported in the Visalia Times-Delta

On June 4, Hanford Police arrested the primary suspect in the disappearance of Debbie Hawk, a Hanford woman missing since June of last year. Dave Hawk, the missing woman’s ex-husband was arrested for a variety of crimes, none of them related to Debbie Hawk‘s disappearance. Hawk was arrested on suspicion of tax evasion, possession of child pornography and other crimes, Hanford police announced Friday.

Confiscated documents and computers belonging to Dave Hawk contained what police and other investigating agencies are calling child pornography. Evidence also revealed that Dave Hawk embezzled money from trusts established for the couple’s three children, according to Hanford police.

Search warrants were also served at the residence and business of Mary Royer, who police believe is Dave Hawk's girlfriend.

Royer shares a bank account with Dave Hawk that was used to dispose of some of the trust assets, police said. Royer has not been arrested, and police said the extent of her involvement, if any, in the alleged crimes remains to be seen.

It is believed that Debbie Hawk, a pharmaceutical representative whose clients included doctors' offices in Visalia, was kidnapped between 10:30 p.m. June 12, 2006, and the following morning.

The charges announced Friday are unrelated to the kidnapping, but Hanford police said Dave Hawk remains the primary suspect in that case. Dave and Debbie Hawk had been involved in an acrimonious dispute over child custody, visitation, and support shortly before her disappearance, said Hanford Police Chief Carlos Mestas.

The trusts established by Dave Hawk on behalf of his children were in excess of $250,000, Mestas reported, adding: "These trusts...had been looted."

According to Mestas, Dave Hawk was using the trust assets for living expenses, and filed documents under penalty of perjury that lied about the source of income.

In addition to charges of tax evasion, embezzlement, and possession of child pornography, Dave Hawk faces charges of grand theft, perjury, and using false documents to obtain a loan. The Franchise Tax Board, the Kings County District Attorney's Office, the California Department of Insurance, the California Department of Justice, the FBI, and the Kings County Sheriff's Department assisted in the investigation.

Anyone with information regarding the disappearance of Debbie Hawk is encouraged to call the Hanford Police Department at (559) 585-2540, or the Hawk Tip Line at (559) 381-9853.

Embezzlement, tax evasion send woman to state prison

A Los Angeles woman was sentenced on June 8 to three years and eight months in state prison on felony charges of embezzling more than $356,000 from her employer and filing false state income tax returns.

Lana Michael, AKA Svetlana Djangarian, 34, was employed as a supervisor at the Glendale office of a community employment-training center. The center is an agency contracted to provide training, job placement, and public funds for transportation to public assistance recipients. Michael had computer access for the issuance of fraudulent warrants.

According to court documents, she was able to authorize the issuance of Los Angeles County warrants on closed cases to other co-conspirators, who conspired to negotiate the illegally obtained warrants, and split the proceeds with her. Michael filed false state income tax returns for 2001-2003 by not reporting the embezzled income.

Michael, who was out on bail, was ordered to pay restitution of more than $62,700 to the FTB in unpaid tax, penalties, and interest.

The buzz on big business

The California Research and Development Credit - is there a documentation requirement?

In the June issue of *Tax News,* we discussed the types of documentation you need to support the research credit. This month we continue the discussion by answering additional audit-related questions like, "What are the specific documentation requirements for the California research credit? Weren’t the documentation requirements removed from the final federal regulations? Are we required to provide contemporaneous support? Can we use estimates?" Here are answers to these questions:

What are the specific documentation requirements for the California research credit?

With few exceptions, the State of California conforms to the federal research credit computation. Treasury Decision 9104 eliminated the "unique" documentation requirements to define qualified research under Treasury Regulation Section 1.41-4(d). However, taxpayers are obligated to follow the broader language of the current Treasury Regulation

Section 1.41-4(d), the requirements of Internal Revenue Code (IRC) Section 6001, and established case law related to record keeping (Revenue and Taxation Code Section 19504; *New Colonial Ice Co v. Helvering*, 292 US 435 [78 L.Ed. 1348](1934)).

Weren't the documentation requirements removed from the final federal regulations?

A taxpayer must maintain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit (Current Treasury Regulation Section 1.41-4(d)). Treasury Regulation Section 1.6001-1 requires the taxpayer to clearly establish full compliance with all of the relevant statutory and regulatory requirements. The regulation requires taxpayers to keep permanent books and records sufficient to establish the amount of gross income, deductions, credits, or other matters for as long as the contents thereof may become material in the administration of any internal revenue law, or in California's case the revenue and taxation law. Simply put, taxpayers must retain all relevant documentation for as long a period as may be required to address a material item: in this case the research credit and its related expenditures and components. Failure to maintain records in accordance with these rules is a basis for disallowing the credit.

Are we required to provide contemporaneous support?

It is also clear from the above regulation and case law that contemporaneous documentation and support are generally required. Contemporaneous means the documentation or support should be from the time period of the underlying transactions, services, or activities. While the state can provide taxpayers with some degree of flexibility in substantiating their credit, this flexibility does not relieve the obligation to keep and provide a record of their qualified research and research expenditures. Extrapolations based upon data from a later period, or estimated qualifying percentages developed years later are not contemporaneous and do not have probative value. For example, if a taxpayer contemplates filing a research credit claim as an existing research entity, for income years after 12/31/99, the taxpayer will need to establish and provide contemporaneous documentation to support the qualified research expenditures and gross receipts from the base period of 1984 through 1988.

Can we use estimates?

As with the IRS, the State of California is not required to accept estimates of qualified research expenses if documentation exists, or should exist, to verify the actual amount. Taxpayers are required to keep records substantiating the amount of any reported, claimed, or affirmatively raised deductions or credits (*Appeal of Don A. Cookston,* 83-SBE-048 (January 3, 1983)). Failure to maintain records in accordance with the above requirements is a basis for disallowing the credit.

However, the courts may allow the use of an estimation method, but only where the taxpayer can prove contemporaneous records do not exist and then only as long as the following two conditions are satisfied:

- The taxpayer must establish that it engaged in qualified research activities as defined in IRC Section 41(d).

- The failure to maintain a proper system to capture relevant information cannot be an "inexactitude of their own making." (*Cohan v. Commissioner*, 39 F.2d 540, 544 (2d Cir. 1930.))

Estimation is a method of last resort, in cases where the sole issue is the exact amount paid or incurred in the qualified research activity, and after supporting evidence has been provided showing a material research activity did, in fact, occur. Accordingly, taxpayers must have factual support for every assumption underlying their estimates to meet their burden of proof. At a minimum, a valid estimation requires some indirect basis.

The Research and Development Credit is a valuable tax incentive benefiting many California business entity taxpayers. In exchange for this tax incentive, a taxpayer must maintain records in sufficiently usable form and detail to substantiate that the expenditures claimed are eligible for the credit. Presenting detailed, well-maintained records to us upon request will help taxpayers in audits of the Research and Development Credit.

You can find additional information on the Research and Development Credit on our Website.